

Basic World Tax Code

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BASIC WORLD TAX CODE AND COMMENTARY

A Project Sponsored by the Harvard University
International Tax Program

1996 EDITION

by

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Foreword

The International Tax Program at Harvard University is pleased to sponsor this 1996 Edition of the Basic World Tax Code (BWTC) which is written by Ward Hussey and Donald Lubick. The idea for the BWTC came from the demonstrated need by developing and transition countries for a legislative framework as they work to formulate modern tax policies and taxation laws. Much of the legal foundation for tax systems in developing countries is found in the laws of former colonial countries who have long since abandoned those structures in favor of taxation systems which are more appropriate for modern business and fiscal requirements. The task facing the transition countries of the former U.S.S.R. and Eastern Europe is considerably more difficult. In their heroic attempt to catch up with the western economic systems, there has been an urge to try to implement some of the most complex aspects of tax systems found in developed countries, while their economies demand a system which is much more fundamental.

Over the past 10 years, there has been a virtual revolution in applied taxation policies in developed, developing, and transition economies. There has been a remarkable consensus formed by tax policy experts of every discipline about the design of effective and stable tax systems to finance the public sector. While the degree of consensus among economists and tax policy experts has been impressive, the tax policies have often run aground when they hit the entrenched views of the existing legal traditions and legislative processes. It is common to find multiple laws applying to the same tax or having multiple administrative laws which apply to the different components of the tax system. At the same time, there is little or no awareness amongst the legal profession that such a tax system is an impediment to progress.

The BWTC was initiated as a modest attempt to provide an example of the laws that are needed for an efficient and effective tax system. The objective was to provide the tax policy and legal experts in the reforming countries with a framework, or a checklist, of what is needed (or not needed) to have the foundation for a system. The response of the potential users of this model tax code has more than justified the effort that has gone into its design and preparation. Over the past two years, the Code has become a standard reference of those embarking on tax reform in these countries. It has been used as a part of the course material in the graduate courses, *Comparative Income Taxation*, and *Value Added Taxation*, at Harvard University and elsewhere. Its immediate translation into Russian has greatly enhanced its usefulness as a practical tool of tax reform in the transition economies.

This project has been blessed by the tremendous expertise of Mr. Hussey and Mr. Lubick. Mr. Hussey's long experience as the Legislative Counsel of the U.S. House of Representatives, and Mr. Lubick's experience as both a tax practitioner and a senior policy maker, has combined to make them a unique team to prepare this tax code.

Since the first discussion draft of the BWTC was made available, Mr. Lubick and Mr. Hussey have been working with numerous countries to assist them in designing or reforming their tax systems. They have also had the benefit of comments from many colleagues who have expressed their views on how the BWTC might be improved. The objective has never been, nor should be, to build a comprehensive tax code with all the details that might arise in each specific country. The goal has been to design a highly professional, but basic, tax code which could provide a solid legal foundation for a modern tax system. Messrs. Hussey and Lubick have written the Basic World Tax Code in a very timely manner while carrying on a heavy load of tax advisory assistance around the world. Their creativity, dedication, and diligence is greatly appreciated by those of us

who are users of their product. The International Tax Program is very proud to have Mr. Hussey and Mr. Lubick as Senior Fellows, and is very pleased to be able to sponsor their second edition of the Basic World Tax Code.

Glenn P. Jenkins
July 1995

PREFACE

At the end of 1992 the authors with the indispensable support and assistance of Thomas Field, publisher of *Tax Notes* and its sister publications, brought forth the Preliminary Edition of *Basic World Tax Code and Commentary*. The genesis of the project was the urging of Glenn Jenkins, Director of the Harvard International Tax Program (“ITP”), that we set in writing the results of extensive work in drafting a proposed tax code for the Dominican Republic. This drafting work was done under the aegis of the Harvard Institute for International Development (“HIID”) and the ITP and was funded by the United Nations Economic Development Program. The policy decisions adopted in the draft were heavily influenced by those developed over many years of technical assistance to developing countries in reform of their tax systems by Professor Jenkins, Professor Robert Conrad of Duke University, Joan Youngman of the Lincoln Institute for Land Policy, Roy Kelly of HIID and ITP, and many others.

Primarily because so many of the formerly socialist countries of central and eastern Europe and the former Soviet Union were in the throes of adopting entire new tax structures or radically revising old ones, we felt an urgent need to provide a sample tax code that might be useful immediately, not only for developing countries but particularly for those economies in transition to one based upon free markets. Had we waited to present a perfect product, the “BWTC”, as it is called, might never have appeared. Neither of us can conceive of producing a product that would be ideal by our own standards, let alone those of the numerous experts in the field.

Our decision to publish immediately, warts and all, has been justified by the use that has been made of the Preliminary Edition. Contrary to fears expressed by some reviewers of the Preliminary Edition, no country has been beguiled into enacting our draft *in toto*, or has failed to receive ample advice (solicited and unsolicited) as to

a myriad of alternatives. Nevertheless we are satisfied (and have been assured) that the BWTC (including the Russian language translation that followed shortly the original English version) gave many countries a benchmark and useful guide to their legislative reform endeavors.

As anyone who has served in the legislative trenches of tax enactments could have foreseen, those making political decisions (both in ministries of finance and in parliaments) found not the slightest inhibition against ignoring our superior (*sic!*) wisdom. We venture the guess that few of our critics ruing our decision to present a *prix fixe* menu rather than *a la carte* choices would prefer the menu served by the legislatures so far.

This is not to disparage in any way the many constructive suggestions made in the critiques that *Tax Notes International* commissioned and published in the summer of 1993. We are grateful to each of the contributors for articulating so well deficiencies in the Preliminary Edition and for suggesting alternative approaches for consideration.

The pace of tax activity in the formerly socialist countries continues as frenetically as before. And we, having another two years of experience in a number of countries, particularly those with economies in transition, have concluded that the melding of suggestions we have received, and the experience we have gained from counselling in those countries, is worth our return to the kitchen to offer our new bouillabaisse. We assure our reviewers that the recipe includes a recognizable infusion of crow.

We know that we are still far from completing a task that will permit us to rest. Nevertheless we hope that there will be general agreement that this edition that we humbly denominate our "1996 Edition" should replace the Preliminary Edition as a working tool.

Our profound thanks to those who commented on the Preliminary Edition, both in print and privately to us. In addition to Professors Jenkins and Conrad, Ms. Youngman and Dr. Kelly mentioned above,

we received detailed invaluable suggestions and corrections during the course of our work from Joel McDonald, Deputy Director of the U.S. Treasury Tax Advisory Program for the Former Soviet Union, Emil Sunley, Assistant Director of the Fiscal Affairs Department of the International Monetary Fund, and our long time friend and colleague, now retired from the Office of Tax Policy, U.S. Treasury Department, John Copeland. Our continuing thanks to Glenn Jenkins for his continuing sponsorship of the ITP, and to Tom Field for his guidance and support, indispensable to the appearance of the original edition and this revision. To name all the others who have earned our gratitude for help and suggestions is beyond our power of recollection. We refrain from trying to list them to avoid slighting anyone by omission.

Ward M. Hussey
Donald C. Lubick

BASIC WORLD TAX CODE

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NC = No commentary for that section

INTRODUCTION

1. In General.

We stated in the Preliminary Edition of the Basic World Tax Code (BWTC) and Commentary that it had been prepared primarily for the use of tax policy makers and administrators in countries with developing economies, or in transition to a market economy. This edition is slanted somewhat more to reflect our experiences since the Preliminary Edition appeared, primarily in the formerly socialist countries of central and eastern Europe and the former Soviet Union. As with the Preliminary Edition, it is hoped that it will also serve as a teaching aid for students of taxation.

This book consists of 2 parts:

1. The BWTC — the text of a comprehensive law establishing an income tax, a value added tax, excise taxes, property taxes, and the necessary machinery to enforce and collect these taxes.
2. A Commentary explaining the text of the law.

The Commentary gives special attention to those areas of the law's text that are either novel or not the traditional approach to the problem at hand.

2. Background for the BWTC.

This draft of the BWTC and Commentary is based upon our experiences in developing countries seeking to reform their fiscal systems to make their revenue raising functions more efficient and fairer, as well as countries converting their formerly socialist economies to market systems. Naturally one code will not exactly fit the economic, social, and political situations of each and every country, but we discerned enough commonality in the problems faced in varying economic circumstances to conclude that it is worthwhile to offer a single draft as a starting point.

The authors do not presume that any country should simply substitute its name for our mythical country of Progresia, change the currency designation to its own, and then enact the Code. The Code is intended to suggest those areas that should be considered as appropriate for inclusion in a tax law to be enacted by a country with a developing economy or economy in transition. Each country must review its own circumstances and needs. For some countries, even though we have left out many of the complexities found in the laws of industrialized nations, the remaining version may be too difficult for their administrators and taxpaying subjects to handle. Others, however, may need to adopt some of the legal rules we have omitted in order to deal with the intricate legal, financial, and transactional situations common in industrialized nations.

It is also apparent that changes will always be necessary to conform terminology to the legal institutions and forms of each par-

ticular country. For example each country has its own set of business entities. Thus, one set of terminology cannot be advanced that will fit all countries and indicate which organizations are to be taxed as separate juridical entities and which are to be treated as conduits (pass throughs) of tax attributes to their owners. Most important, the procedural devices used to afford administrative and judicial remedies and enforcement vary from country to country. Nevertheless the Code tries to suggest solutions to problems common to all tax laws regardless of the variance in names given to entities and the remedies now prevalent in any particular country.

We also decided to use assumed concrete numbers for rates, time periods, thresholds, and everything else where the choice was between a number and a blank space. We followed that practice primarily because we find that concrete numbers help the reader conceptualize the policy. Our selections of rate schedules, time periods, and the like do, however, reflect a policy preference as to general magnitude. For example, our selection of a three year statute of limitations or a 30% rate of entity profits tax is not intended to imply that four or five years, or 25% – 33% would be folly. It would be fair to infer, however, that we would question seriously a ten year statute of limitations or a 60% rate of tax.

There are a number of instances where we chose among competing alternatives and others might prefer a different route from ours. We try to discuss some of those options in this introduction and in the Commentary.

A number of commentators on the Preliminary Edition suggested that we should have drafted alternatives to almost every choice that we have made in our sample (*n.b.* not “model”) code. We are unconvinced. To have prepared and described all the alternatives would have been an endless work. The delay would have precluded emergence of a timely useful guide to decision making. That holds true of this edition as well.

Furthermore we were not, and are not, preparing a form book for tax legislation. Presenting a bewildering array of options impedes, and possibly precludes, the understanding by the user of an integrated whole. The number of changes in a unified draft that would result if one option were changed would be multiplied many times over if we attempted to show the effects of that changed option when coupled with each of the other options.

We therefore have limited ourselves to suggesting, but not drafting, some of the principal alternatives. We continue to adhere to the concept of presenting our preference for the most workable integrated scheme at a fairly early stage of implementation. We recognize that others may differ and that our “one size” does not “fit all.”

The Commentary also tries to flesh out the bare bones of the statute to lay the foundations of a body of administrative regulations interpreting the BWTC provisions. We believe that brevity and simplicity in the statute are superior to massive detail. We recognize a danger in allowing administrative latitude to tax administrators who may abuse their powers of interpretation. We believe, however, that

the greater danger lies in attempting to particularize the statutory language in an attempt to cover all situations that we can conceive. In any event, interpretative decisions by the tax administrator are inevitable, whether they are called “regulations” or some other name. It is far better to make these administrative policy decisions available in written form to all taxpayers, than to leave them to haphazard word of mouth. Furthermore, it is understood that a regulation that goes beyond the statutory rules is illegal and can be adjudged such in a remedial proceeding initiated by a taxpayer. We hope that the statutory guideposts are firm enough to prevent the tyrannical arbitrariness that some reviewers of the Preliminary Edition fear, no more than we.

3. Drafting Style.

The Code has been drafted in a style that emphasizes clarity of organization, consistency and precision of expression, and economy of words. This drafting style may be a stark contrast to that found in some countries, where lack of organization by subject matter, imprecise and inconsistent numbering and paragraphing, and verbosity and superfluous expression abound. The drafters in these countries are likely to dismiss our draft code as too “Anglo-Saxon” or too “foreign.”

We believe, however, that in every country tax laws should be drafted so as to set forth for taxpayers, tax administrators, and the courts the tax rules for that country in a way that is clear, simple, and understandable. This can be accomplished only if there is precision of thinking, coupled with precision of expression. This precision will be encouraged by a clear organization of topics, a consistent pattern for

organizing ideas within topics (starting with the most important ideas), a consistent pattern for numbering and paragraphing, precise use of terminology, elimination of extravagant use of synonyms, and economical expression. We believe that these drafting principles embodied in the Code can be usefully incorporated in tax laws drafted in any language.

We certainly do not intend to be patronizing in our hope that we can contribute something to good legislative drafting. Nor does our sometimes use of “Americanisms” — ways of expressing concepts in terminology used in the United States — carry any implication that the U.S. term of art is the *mot juste* in any one case. We thought of using terminology borrowed from France, Germany, the U.K., et al., but realized that it would be rare that any of our terms would be enacted in English. Since any BWTC provision that is enacted will necessarily be translated into another tongue, we leave to the translator the choice of the appropriate local idiom.

4. General Principles.

The BWTC rests on a number of assumptions or principles, both overall and in the case of each of the 4 categories of taxation.

For example, it is assumed that it is desirable to collect all laws relating to taxation in one place so that revenue demands can be judged from an overall perspective, as well as to contribute to the ability of taxpayers and administrators to find all relevant statutory material. It is further assumed that this can best be implemented by having a

permanent law to which all amendments are made, rather than by enacting a supplemental or independent law each time the government needs money or chooses to change a policy. At any given time anyone can determine the statutory law by a search in one place.

Many countries permit changes in operative law by an executive decree subject to legislative rejection, if not subsequent approval. In such countries a code is even more important because changes seem to be more frequent and transitory. It is hard for taxpayers, their advisors, and even administrators to keep *au courant*. In such case the code should perhaps include a section requiring the practice of retaining only decrees currently in force and discarding those that are revoked.

It is assumed that simplicity, clarity, and understandability are desirable goals for the law. Wherever practicable, this should be coupled with certainty, but certainty as to overall direction (as opposed to the detailed elaboration necessary to assure sophisticated taxpayers that their latest tax avoidance schemes will succeed).

It is assumed that an emerging economy will do best if it becomes an efficient producer in the world economy. Thus it is believed not to be in a country's best interests to adopt a protectionist system of taxation that favors domestic interests over investment coming from abroad, or that favors particular segments of the domestic economy by tax holidays or other tax subsidies. The assumption is that any such tilting of the playing field will result in the long run in a misallocation of labor and capital resources and in a less prosperous and stable

economy. This goes hand in hand with a firm belief that where economic subsidies are necessary, it is usually less efficient to use the tax system than to pay a direct subsidy to the activity involved. Use of the tax system imparts a degree of permanence that preserves the subsidy long past the period of its need, complicates and undermines efficient enforcement of the revenue laws generally, introduces government intervention through revenue officials who are not equipped to police the qualifications of those subsidized, and, most important perhaps, is inefficient because of the inflexibility inherent in defining the proper objects of the subsidy in tax law terms.

Such tax preferences inevitably direct government resources in large measure to unintended beneficiaries. They distort market influence on efficient allocation of resources. They frequently favor foreign investment and impede the development of indigenous competitive entrepreneurship. In the worst situation they transfer money to the treasuries of rich industrialized countries by reducing the credits the industrialized countries will have to grant for foreign taxes. Thus, the BWTC eschews exonerations, exemptions, tax holidays, and other special preferences and deals.

In devising the particular tax system contained in the BWTC, it is assumed that the bulk of an emerging economy's revenue will come from customs revenues, the value added tax, selected excise taxes, and the entity income tax. All of these sources have the added advantage that the administrative cost for each unit of revenue raised will be lower than under an individual income tax. Many of the former socialist

countries, however, retain heavy payroll taxes or broad based schedular income taxes on employment compensation to finance social benefits. These countries are not likely to be able, or to want, to modify their benefit entitlements significantly, and so those payroll taxes will be retained as taxes on employers and the self employed. We hope to include some sample language in this area in a future edition.

We have included in this edition language to permit the integration of an income tax on wages as a final tax on almost all wage income without the need for extensive filing of returns. Almost everywhere we have found a widespread desire for fairness (based on ability to pay) that demands an individual income tax. Thus, the BWTC contains a combined individual and entity income tax, but we have tried to confine the individual income tax (aside from the option of the schedular wage tax mentioned above) to a small percentage of the population, all with comparatively high incomes. The emerging economies, whether developing countries or formerly socialist, do not have the administrative resources for return-based individual income taxes applying to a large percentage of the population, as is the case in the industrialized countries. Neither the administrators nor the populace has sufficient “tax literacy” or accounting capacity to make a universal individual income tax based upon individually filed declarations a worthwhile subject of administrative resources. For the broad mass of the population with hardly any saving capacity, it matters little whether their taxes are paid through direct or indirect taxation. Hence, the individual income tax in the Code is designed less for revenue produc-

tion than for satisfying notions of equity of contribution to the cost of government — the addition of a dollop of progressivity to the revenue stew.

We have combined the individual income tax and the enterprise profits tax into one title. So many of the concepts are identical that the repetition required by separate titles seemed needless. A country that desires a separate enterprise tax can with reasonable facility simply delete those provisions relevant only to individuals and vice versa. We do recognize, however, that for many developing countries schedular withholding taxes applied as final taxes without return filing is appropriate for wages and interest.

In addition, taxes on movable and immovable property have been included both as a second way of satisfying the desire for a “fair” tax system and also as a method of establishing a stable revenue base that may be assigned or allocated to regional and local governments.

In the Code there is a built in provision for adjustments for inflation, because periodic episodes of double digit inflation seem to be endemic to emerging economies and can swiftly wreck the best drafted tax law unless their effects have been foreseen and provided for. On the other hand in some situations it may be wiser to defer a commitment to a complex permanent indexing system in favor of *ad hoc* adjustments that will serve until a short term inflation is brought under control.

Finally, the BWTC is based on the assumption that the design and drafting of laws is only the prelude to the major necessity of tax

reform — development of the tools of effective administration. An honest and highly competent tax administration is a must. Tax administration must be given the legislative framework, but what is done to implement that framework will in the final analysis determine the success of tax reform.

Now to turn to a few of the assumptions and principles underlying each of the 5 titles of the BWTC.

5. Principles Underlying the Income Tax.

As stated above, there is widespread pressure to levy an income tax both on the income of individuals and on the income of business enterprises.

In the BWTC these 2 areas are combined by imposing one income tax to which all persons (natural and juridical) and all business activities (including the business activities of central and local governments and of non profit religious or charitable, trade, and labor organizations) are subject.

The tax is broad based. It sweeps in income of all kinds, treating capital gains in the same way as any other income. And it allows very few deductions. The chief of these is the deduction for the expenses necessary to produce the income.

In the individual income tax the desired progressivity is achieved by a zero bracket amount that would likely exclude the great bulk of the working population. If, however, additional allowances are to be provided for dependents, they should be granted by way of additional

personal credits directly against tax liability in order to focus relief on lower incomes (whereas additional exemption or zero bracket amounts per dependent would give more benefit to high bracket taxpayers). Administration is helped not only by the sharp drop in the numbers of persons subject to tax by reason of the zero bracket, but it is also helped by the fact that the income tax will be collected mainly by withholding at the source.

As mentioned, if for political or revenue reasons it is necessary to include in the income tax a tax on levels of employment compensation below the top of the zero bracket that will apply to a broad range of population, we have shown how it can be done by a no return schedular final withholding tax on wages.

The BWTC proposes a top rate for individuals of 30%. This coincides with the one 30% tax rate for entities. Our rate scale for individuals is progressive with two rates above the zero bracket. We have designed the zero bracket so as to eliminate from the tax base at least 80% of Progresá's individuals receiving income. Furthermore, the wage withholding system set forth in section 171 is designed to eliminate perhaps another 15% of the population from the requirement of filing income tax returns. Withholding will have satisfied the full tax liability of those taxpayers who have only wage income or other income (such as interest) subject to final withholding. Countries modeling their individual income tax upon Progresá's will have to devise the rate scale appropriate for them.

The BWTC also has provisions under which much of the double taxation of dividends of entities is eliminated. Thus, the BWTC does much to establish a level playing field for business activity — with an identical rate of 30 percent whether the activity is carried on by a proprietorship, a partnership (or other pass-through entity), or a corporation (or other juridical person). We mention in the detailed commentary that some countries may impose additionally a second low rate final withholding tax on distributed dividend income and point out the ramifications such a second tax would have in the areas of intercorporate dividends and the domestic branch operations of a foreign entity.

The BWTC income tax rests upon a number of policy decisions worth comment at this point. The actual details of implementation are amplified in the Commentary.

A. Single Taxation of Entity Income.

This is not the place for a detailed discussion of the theoretical merits of the classical vs. integrated or partially integrated methods of income taxation of entities and their shareholders or of the incidence of the entity income tax. Emerging economies do not have developed markets to raise capital for large corporate enterprises. The entity income tax will generally apply, at the stage of economic development for which the BWTC is designed, to foreign corporations engaged in business in the country and to closely held enterprises of budding entrepreneurs. The case for double taxation of entity income is weakest in such an environment. Closely held enterprises seem to be able to

integrate by self-help devices, such as the payment of deductible salaries to owner-employees, even in developed countries. Foreign corporations should be encouraged to invest by taxing them at a rate that is competitive with the rates of other countries, while assuring them that taxation will be applied to as full a base as possible.

We could have provided a tax credit at the shareholder level for entity tax paid. This would have led to the filing of returns by all shareholders. Instead, with the individual tax applied at the same rate as the entity tax (except for income up to a relatively low threshold), the simplicity of the advance corporate tax method we have chosen was best suited for our purpose. Under this method all distributions (other than those in complete liquidation) are grossed up by 30% and are subject to withholding at 30% (which is credited against entity tax liability). As a result, tax preferences that may serve originally to reduce corporate income provide no benefit that reduces withholding at the time of distribution. If distributions exceed entity taxable income because the latter is reduced by preferences, the withholding tax will exceed the entity tax liability and lose its value as an offset. Note that the 30% tax applies to entity income regardless of whether the shareholder is a non-profit entity, a government, or a foreign individual. The usual vexing problems of tax integration are by-passed in the BWTC. Progresa derives a 30% tax from all entity equity business income sourced within its borders, no matter who the ultimate owner of the income is. In general, there is no further tax on the owner as dividends subject to the withholding tax are excluded from the recipient's income.

The principal element of double taxation that remains consists of gain on the sale of stock to the extent the gain is a reflection of retained (and hence once taxed) earnings.

As stated in the previous paragraph, the draft imposes a withholding tax on distributions that may be offset against entity tax liability. This is a complication compared to a simple exemption of dividends. In a perfect world — an entity tax without preferences — distributions could be exempt and the full single tax would be collected at the entity level. As has been noted experience teaches that the pressures to reduce entity income tax by base narrowing preferences are difficult to resist. Hence, the withholding tax serves to bolster full collection of one level of taxation. The likelihood of flowing the preferences through to shareholders on distribution is substantially less than the likelihood that there will be, in spite of contrary advice, preferences at the entity level.

B. Interest Deductions.

Only business interest is deductible, and in any year the deduction in the case of foreign owned entities and business activities owned by tax exempt entities is limited to business interest income plus 50% of other business income. This limitation is designed to discourage income stripping through excessive ratios of debt to equity. Since interest paid to foreign lenders is subject to only a 15% withholding tax (and zero if paid to a tax exempt lender), allowing “thin” corporate capitalization could result in foreign investors paying tax at half the 30% rate on income returns to equity. Although the limitation can cause

some hardship for a start up business with little or no income and heavy debt, that is mitigated by an indefinite carryover of deferred interest deductions. The rule applies even to interest paid to an unrelated lender, because of the lack of enforceability of measures against avoidance arrangements between owners and the nominally unrelated lenders.

C. Capital Gains.

Again, this is not the place to deal with the policy issues of a capital gains preference. We opted for full taxation of capital gains given the following considerations:

(i) Under the Code the inflationary portion of capital gains will be eliminated for the most part. Section 79 provides that the basis of assets will be indexed for periods of more than moderate inflation.

(ii) Real (as opposed to inflationary) gains have a tax advantage over other income. They are not taxed until they are realized (usually by voluntary disposition of the asset by the taxpayer) even though they may accrue over a period of years before disposition. Thus, capital gain taxation only on realization provides an inherent benefit of tax deferral.

(iii) A capital gains differential is the major source of complexity, both in terms of planning and administration.

(iv) Integration of entity and shareholder taxation precludes most double taxation.

(v) With the low rates, full taxation of capital gains is vital to carry out the equity goals and to maintain the incentive impact of low rates.

D. Fringe Benefits.

The greatest complexity and base erosion in the compensation area in individual income taxes is the escape from taxation of fringe benefits, through non taxability or difficulties of valuation at the individual taxpayer level. A tax favored position for fringe benefits is also a significant source of distortion in economic decision making.

We have made the employer the surrogate for taxation to the individual by proposing a single tax at the employer level at the 30% rate of the grossed up (by the 30% tax rate) value of fringe benefits provided. We do not need to allocate values among individual recipients, and in many cases the cost to the employer will provide an easy measurement for administration that will closely approximate value. (Discounts and use of employer facilities are areas in which cost to the employer may not be appropriate, but it will still be easier to value as an aggregate at the employer level).

E. Simplified Depreciation.

The depreciation deduction has been greatly simplified by placing depreciable assets (other than buildings) in 2 pools and then allowing each year the deduction of a constant specified percentage of the balance in each of the pools. Vintage accounts are needed only for buildings. Some issues on the advantages of group accounting and the

relation to financial accounting are discussed in the detailed commentary.

F. Low Rates — Broad Base.

The low rates applied to virtually all economic income will increase efficiency by minimizing the tax deterrent to additional income producing effort — whether from labor or investment — at the margin. The broad base will help assure the market to be the determinant of economic decisions and will assure fairness. In fact, the reach of the BWTC to a broad income base will produce as much progressivity and “bite” on high incomes as the more common high rates applied to preference riddled bases in most industrialized countries.

6. Principles Underlying the Value Added Tax.

Presenting a draft of a value added tax at this stage of the almost worldwide acceptance of that tax may be foolhardy. So many countries have taxes in this area (whether called value added taxes, sales taxes, turnover taxes, production and wholesale taxes, or whatever) that the supply of laws and proposed laws to serve as models seems inexhaustible. Almost every possible variation has been proposed in at least one country. And yet the number of simple value added tax laws is very small.

At the same time, for East European countries hoping for eventual membership in the European Union, a strong case can be made for drafting their value added tax by using the language set forth in the Sixth Council Directive of the European Union.

However, to insist that these countries start out with the full text of the Sixth Directive will in most cases court rejection by the legal drafters or legislatures in these countries. In our work we have found that it is easier to convince policy makers of the need for changes in their tax concepts than it is to convince the persons charged with the language of the law to use the precision and complexity found in the tax laws of most industrialized countries. We have therefore prepared a value added tax which uses fairly simple language and concepts, but at the same time captures the important principles of the Sixth Directive. Thus, when the time for admission to the European Union arrives, the second step, of greater conformity, will be a relatively easy matter.

The value added tax contained in Title II is based on 6 general principles:

- A. The net tax will be measured by the difference between the tax on the seller's output and the tax on the goods and services used in the seller's business.
- B. To evidence this difference, invoices will be used.
- C. The value added tax will apply not only to production and wholesale activity, but also to retail activity.

D. For revenue reasons and to ease compliance and administration, the tax will be broad based in its application to goods and services, with exceptions kept to a minimum.

E. There will be only one rate of tax (aside from a zero rate for exports).

F. The tax will apply equally to imports and domestic production (so as to avoid misallocation of resources).

This draft is based on our experience working with policy makers and tax administrators in a number of countries. In all of them we were pushed to recommend bending of the 6 general principles or alternative solutions (multiple rate systems, exemptions for food, a small trader exemption, special breaks for farmers, and so forth).

It will be noted that in this draft we gave some ground — we have a small trader exemption (which will include most small farmers). We also excluded certain transactions.

But we hope that we have presented a framework for understanding how a VAT works and for fashioning a law or amendments that will meet your country's needs.

7. Principles Underlying the Excise Taxes.

The principles underlying the excise taxes contained in Title III are:

A. That to ease tax collection burdens, the taxes should be levied on a relatively few taxpayers, should be levied on a

relatively few articles, and should be levied at a relatively few rates.

B. That the taxes should be based on the value of the article rather than on units (such as weight, volume, bottles, packages, or similar units).

C. That imports and domestic production should be treated evenhandedly to avoid misallocation of resources.

The BWTC has a relatively novel idea in the excise tax area. Taxes are imposed on domestic alcohol and tobacco products and on motor fuels at the time of production. Administrative considerations dictate the fewest number of taxpayers, hence the preference to collect from producers, not retailers. However, the amount of the tax is based on the retail price current at the time of production to achieve a uniform and large base without competitive advantage to vertically organized enterprises. The current retail price is determined through periodic surveys of retail prices by the Central Bank.

8. Principles Underlying Property Taxes.

The BWTC also contains in Title IV three property taxes. The first is an *ad valorem* tax on land and buildings; the second is an *ad valorem* tax on motor vehicles; and the third is a tax on the gross assets of large resident entities that serves as a minimum tax which applies to the extent it is not equalled or exceeded by the income tax.

The inclusion of the tax on land and buildings is dictated not only by a desire for “fairness” in allocating the tax burden on perceived

ability to pay but also by another factor. In many countries there will either be the absence of, or a complete breakdown of, a system of real property taxation. This will be coupled with a desperate need of municipalities and rural areas for revenue for schools, roads, water, sewers, and other infrastructure.

The proposed taxes on immovable property and motor vehicles are national taxes, but the revenues (after administrative costs have been paid) could be turned over to the municipalities and other local governments. Alternatively these taxes could be administered by localities, using either or both of the taxes proposed here to serve as the starting point for legislation imposing regional or local taxes instead of a national tax.

The tax on land and buildings imposes both *in rem* liability on the property and personal liability on the owner. The *in rem* approach will be appropriate in many countries because of an inadequate or nonexistent state of title registration.

The tax is levied property by property, but all property in the country is divided into categories and then into zones. The property within each zone is valued on a uniform basis. For each zone a per square meter factor will be established for the underlying land in each property (based on its area), and a second factor will be established for buildings on the land (based on replacement cost less depreciation) and applied to usable space. The sum of the two taxes is the tax on the particular immovable property. There will be periodic surveys to

redetermine these factors, and in the meanwhile there will be annual adjustments for inflation based on the national adjustment figure.

This procedure eliminates the need for an initial assessment of each tract or parcel of land and for annual reassessments.

The third of the property taxes, the tax on gross assets of large commercial entities is intended as a temporary backstop to the income tax until the tax administration of the country is able to cope with the complexities of administering the regular income tax. We recognize the economic drawbacks of this tax, but given the revenue needs of a particular country, and its inability to police adequately its income tax, the tax outlined here is offered with the misgivings and qualifications stated in the detailed comments below.

9. Relative Sources of Revenue.

We have included in our sample code only provisions for taxation of business profits and individual income, a value added (consumption) tax, and selective excise and property taxes. We have not included samples of payroll taxes to finance social protection funds, wealth transfer taxes, customs duties, special taxes on natural resource exploitation, most user fees, and other minor revenue producers.

Readers may be interested in the sources of revenues in various countries. Hence the following data are cited from the OECD publication, *Revenue Statistics of OECD Member Countries. 1985-1993* (OECD Paris 1994). We give 1992 statistics below, the latest complete ones available.

Tables 1 and 2 set forth statistical data set forth in Tables 7 and 6, respectively, of the OECD publication. The revenues include amounts collected by regional and local governments as well as by the central government of each country. Table 1 contains an unweighted average for all OECD countries for 1992. This shows that they derived the following percentages of total taxes from the 6 headings used in the publication:

Heading	Percentage
Income and Profits	37.0
Goods and Services	30.3
Social Security	25.0
Property	5.5
Other	1.3
Payroll	0.9

In these tables, the heading “Income and Profits” also includes capital gains. “Social Security” refers to compulsory contributions earmarked to provide social security benefits. “Payroll” refers to taxes paid by employers, employees, and the self-employed (either as a proportion of payroll or as a fixed amount per person) that are not earmarked for social security benefits. “Property” refers to recurrent and non-recurrent taxes on the use, ownership, or transfer of property. The category includes taxes on movable and immovable property; net wealth, estate, inheritance, and gift taxes; and taxes on financial and capital transactions. “Goods and Services” refers to taxes on the production, sale, transfer, leasing, or delivery of goods or the performance of services. The category includes, among others, sales, value added,

Table 1
Tax revenue of main headings as percentage of total taxation
1992

	Income & Profits	Social Security	Payroll	Property	Goods & Services	Other
Australia	55.4	—	7.3	10.0	28.4	—
Austria	26.9	33.0	6.0	2.7	30.2	1.4
Belgium	36.0	36.0	—	2.5	25.5	—
Canada	45.0	16.5	—	11.1	26.1	1.4
Denmark	59.5	3.1	0.7	4.0	32.5	0.2
Finland	42.8	23.2	—	2.2	31.6	0.2
France	17.3	44.6	2.1	5.0	26.8	4.2
Germany	32.0	38.4	—	2.7	26.9	—
Greece	18.2	30.7	0.6	4.4	46.1	0.1
Iceland	29.6	7.9	0.1	9.1	50.0	3.4
Ireland	38.8	15.3	1.3	4.4	40.2	—
Italy	39.1	31.3	0.3	2.4	26.9	—
Japan	42.4	32.8	—	10.5	14.0	0.3
Luxembourg	35.4	28.4	—	7.9	28.4	—
Netherlands	31.4	38.8	—	3.6	25.8	0.5
New Zealand	56.7	—	1.4	6.5	35.4	—
Norway	32.2	26.7	—	3.1	37.1	0.9
Portugal	28.8	25.4	—	2.3	43.0	0.4
Spain	30.2	36.6	—	4.7	28.5	0.1
Sweden	38.5	28.8	2.5	3.7	26.5	0.1
Switzerland	41.0	34.9	—	7.1	17.0	—
Turkey	32.5	20.4	—	2.0	29.8	15.3
United Kingdom	36.1	17.8	—	7.9	34.4	3.7
United States	41.5	29.9	—	11.4	17.1	—
<i>Unweighted average:</i>						
OECD Total	37.0	25.0	0.9	5.5	30.3	1.3
OECD Europe	34.0	27.4	0.7	4.3	31.9	1.6
EEC	33.6	28.9	0.4	4.3	32.1	0.8

Table 2
Tax revenue of main headings as percentage of GDP
1992

	Income & Profits	Social Security	Payroll	Property	Goods & Services	Other
Australia	15.8	—	1.8	2.8	8.1	—
Austria	11.7	14.3	2.6	1.2	13.1	0.6
Belgium	16.3	16.4	—	1.1	11.6	—
Canada	16.4	6.0	—	4.0	9.5	0.5
Denmark	29.4	1.5	0.3	2.0	16.0	0.1
Finland	20.1	10.9	—	1.0	14.8	0.1
France	7.6	19.5	0.9	2.2	11.7	1.8
Germany	12.7	15.2	—	1.1	10.6	—
Greece	7.4	12.4	0.2	1.8	18.7	—
Iceland	9.9	2.6	—	3.0	16.7	1.1
Ireland	14.2	5.6	0.5	1.6	14.7	—
Italy	16.6	13.3	0.1	1.0	11.4	—
Japan	12.5	9.7	—	3.1	4.1	0.1
Luxembourg	17.1	13.7	—	3.8	13.7	—
Netherlands	14.7	18.2	—	1.7	12.1	0.2
New Zealand	20.4	—	0.5	2.3	12.7	—
Norway	15.0	12.4	—	1.4	17.3	0.4
Portugal	9.5	8.4	—	0.8	14.2	0.1
Spain	10.8	13.1	—	1.7	10.2	—
Sweden	19.2	14.4	1.2	1.8	13.2	—
Switzerland	13.1	11.2	—	2.3	5.4	—
Turkey	7.5	4.7	—	0.5	6.9	3.5
United Kingdom	12.7	6.3	—	2.8	12.1	1.3
United States	12.2	8.8	—	3.3	5.0	—
<i>Unweighted average:</i>						
OECD Total	14.3	9.9	0.3	2.0	11.8	0.4
OECD Europe	14.0	11.3	0.3	1.7	12.9	0.5
EEC	14.1	12.0	0.2	1.8	13.1	0.3

excise, import, and export taxes. And, finally, “Other” includes amounts that cannot be assigned to the other categories (such as interest, fines, and penalties not attributable to a particular tax).

Readers who wish more than a very rough notion of reliance by OECD countries on particular sources are urged to study the detailed analyses and definitional explanations of the OECD publication.

10. Important Areas Not Covered

A tax code is most effective if it is as comprehensive as possible. It facilitates administration if both administrators and taxpayers need look only to one document (the code) as the source of all tax law. The BWTC is not complete in this respect. We list here three areas that might well be added to a code that we hope we can treat in future revisions.

A. *Social insurance contributions.* In the economies in transition these are usually levied on employers’ payrolls at extremely high rates — as much as 45%. Such taxes on labor have a deleterious economic effect on workers’ incomes, discourage employment, are of a magnitude to discourage compliance and encourage evasion, and generally make more difficult the transition to a market economy. Further there is a lack of coordination between the tax administration and the social insurance administration, both in enforcement and record keeping.

We believe that there should be a common numbering system for taxpayers and social insurance record keeping, that the tax administration is best suited to collect the contributions along with withheld

income taxes, and that ultimately benefits should be geared to contributions, rather than being dependent perhaps one half or more on unreliable infusions of appropriations from general revenues. The social insurance administration could do much of the initial accounting for collections, as well as crediting to individual accounts. Until the social insurance system is stabilized and reformed, it will be difficult to develop a private pension system.

B. *Natural Resources*. The regular profits tax should apply to extractive enterprises and our income tax does so. Since the state is usually the owner of the resources, additional compensation may be appropriate. The options are thoroughly dealt with by Nellor and Sunley, *Taxation of Natural Resources in Developing Countries*, International Institute of Public Finance, 50th Congress, Cambridge, MA, 22-25 August 1994. In addition questions of environmental taxes should be dealt with in this and other contexts.

C. *Fiscal Federalism*. We have not discussed problems of the administration and division of revenues between the national government and lesser subdivisions. Should certain taxes be assigned to local governments for administration, revenue sharing, or both? If there is to be assignment to localities, who receives the revenue attributable to entities operating broadly? The location of a principal office would seem to be an unsatisfactory determinant. Perhaps the use of an allocation formula based upon factors such as property, payrolls, and sales might be recommended for allocations of taxes on business activities.

11. Principles Underlying the Administrative Provisions.

Finally, the BWTC contains a Title V on administration. Power and responsibility are centralized in one official, the Tax Administrator, who we hope will be insulated from the shifting political currents of the day. This was done to enable the building of a professional non partisan staff of wise and fair law enforcers. Of course, the Minister of Finance will play a role in tax policy decisions, but the carrying out of legislative enactments should be free from political whims and caprice. The Tax Administrator will delegate the performance of particular functions to designated tax officials in the Tax Service, but overall responsibility will remain with the Tax Administrator. The Tax Administrator has authority (with the approval of the Executive Power) to organize and reorganize the Tax Service in the most efficient manner. We recommend a functional organization rather than separating administrative tasks by particular tax or type of taxpayer.

In addition, the provisions of Title V are based on the following principles.

A. The technology revolution has made such rapid strides over the past few years in computers and related hardware and software that a developing country, starting from scratch, can at a relatively low cost leapfrog the information collecting, analyzing, and utilizing systems in effect in many developed countries.

B. By centralizing information with respect to trade (imports and exports) and domestic taxes in one data base, income

and articles escaping tax will become much easier to spot, and audit proficiency will increase.

C. Emphasis must be placed on building and maintaining a blue-ribbon tax administration that will be honest, efficient, fair, and career oriented.

D. Emphasis must be placed on education — not only education of the tax officers and employees but of the public at large. In this endeavor also computers will play a major role.

E. Finally, a sea change in the attitude of the public must be brought about. They may never get to love their tax collector, but they will pay their taxes because they think that on the whole the system is fair, that other people are paying, and that they damn well better.